DIRECT TESTIMONY

OF

GENIO STARANCZAK

PRINCIPAL ECONOMIST

TELECOMMUNICATIONS DIVISION

ILLINOIS COMMERCE COMMISSION

AMERITECH ILLINOIS

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What is your name, title and business address?

A. My name is Genio Staranczak. I am employed by the Illinois Commerce Commission as principal economist in the Telecommunications Division. My business address is 527 East Capitol Avenue Springfield, Illinois 62701.

Q. Please describe your educational background and previous job responsibilities.

A. I earned my Bachelor of Arts degree in economics from Lakehead University in 1972 and a Doctor of Philosophy degree in economics from Queen's University, Kingston, Ontario Canada in 1979. In 1977 I began a 20 year career with Bell Canada as an economic forecaster first on a regional and then on a national basis. During the six years I worked directly on economic forecasting, I participated in a series of yearly rate cases.

In 1983 I worked on special assignment to examine economic policy issues related to a forthcoming long-distance competition regulatory proceeding and drafted evidence in this regard. In 1986 I became Director - Policy and Performance where I continued to analyze telecom policy issues, conducted total factor productivity studies, price responsiveness analyses and was responsible for developing revenue forecasting methodologies. For the years 1986-1995 I worked on other regulatory issues such as expanded local calling areas, measured local service, costing studies as well as participating in another general rate case and working on revenue forecasting issues. During this period I published two articles in telecommunications journals on competition and rate rebalancing. I also participated in a number of telecom industry conferences as a speaker. In addition, for eight years, I was a member of Statistics Canada Price Advisory Committee which counsels the government on measurement methodologies for the consumer price index.

In 1995 I became Director of Price Cap Regulation where I was primarily responsible for putting together the price cap formula, including the inflation term and the "X" factor. I also authored the methodology used for measuring total factor productivity and input prices adopted by Bell Canada and most other Canadian telephone companies who participated in the price cap proceeding. In addition, I advised on other alternative regulation issues including construction of the baskets, pricing flexibility and rate rebalancing. For the last three years I was Director of Long-Term Forecasting for the US economy at the WEFA group, a macroeconomic forecasting and consulting firm based in the Philadelphia area.

Q. What is the purpose of your testimony?

A. The primary purpose of my testimony is to present modifications to Ameritech Illinois' (AI or the Company) price cap formula that would improve the operation of the alternative regulation plan. These proposals correct shortcomings in the current regime and reflect recent productivity and price performance. I will then rebut arguments put forth by Company witnesses concerning productivity and the operation of the price cap formula. I start my deposition with a brief discussion of how alternative regulation has worked so far.

PRICE REGULATION SHOULD CONTINUE FOR AMERITECH ILLINOIS

Q. How has alternative regulation worked in Illinois?

A. Alternative regulation has worked reasonably well in some respects but has not worked well in other respects. For example, service quality by some measures has deteriorated. In addition, alternative regulation may have provided Ameritech the opportunity to classify services as competitive, when in fact effective competition did not exist. As a consequence, subscribers paid higher prices for these services than would have otherwise been the case. On the other hand, price regulation has resulted in rate cuts for subscribers of non-competitive services while keeping basic service affordable. Price cap regulation has also eliminated the need for time consuming, burdensome rate cases.

Q. What should the Commission do as a result of this alternative regulation review proceeding?

A. The Commission should allow the plan to continue but make certain adjustments that would better address the service quality issues that have arisen. In addition the components of the price cap plan including the price index and “X” factor should be changed to reflect new and updated information. The next section of my testimony will describe these adjustments. The issue of competitive reclassification is being examined in Docket 98-0860.

Q. Should the Commission impose an earnings “true up”?

A. If these earnings were due to superior productivity performance the Commission should not impose a “true up”. A “true up” (i.e., resetting rates for Ameritech Illinois that would allow the Company to earn its cost of equity in the test year) would be inconsistent with the principle of alternative regulation which is to focus on prices, not earnings. If under alternative regulation, Ameritech Illinois achieves “productivity gains” in excess of the those proscribed in the price cap formula, then it should be allowed to keep these gains. An earnings “true up” would blunt the incentives given Ameritech Illinois to be more efficient since the “true up” would in effect take these gains away. In addition an earnings “true up” would be a step backward towards rate of return regulation. A “true up” would require detailed analysis of rates of return, capital structures, the size of the non-competitive rate base, depreciation schedules, expenses and revenues - actions that are inconsistent with the evolution of a competitive marketplace. Under alternative regulation subscribers receive a guarantee that their overall rates will rise less than general inflation while Ameritech gets the opportunity to earn higher returns. If

Ameritech does indeed earn higher returns under alternative regulation this should not be interpreted as a failure of the plan but recognized as one of the possible outcomes that was anticipated.

If Ameritech boosted earnings by reclassifying services as competitive and then raising prices of these services because effective competition did not exist, the Commission should move the services in question back into the non-competitive category. In addition, the criteria for declaring services competitive should be made more stringent. The Company did not act illegally by having the services declared competitive. Moreover, the criteria for classifying services as competitive were not established by AI but by the Legislature. Again, an earnings “true up” is not in order because the Commission should focus its attention on price performance and not earnings performance. However, the Commission could opt to cut rates for the services in question once they are moved back to the non-competitive category. The rate cuts would move the price of these services to what they would have been had they remained in the non-competitive category throughout the price cap period.

Finally, if the Company boosted earnings by not hiring enough technicians and allowing service to deteriorate as a result then the Commission should toughen the service penalties to such an extent that it would not be in the Company’s interests to let this happen in the future. Although a permanent rate cut under these circumstances may appear justifiable it is not the appropriate solution. A permanent rate cut would reduce Company revenues every year in the future from what they would have been without the rate cut. AI would be penalized indefinitely for a service quality problem of limited duration. However, if the Commission believes that an adjustment to rates is warranted, it could implement rate rebates to better reflect the quality of service currently rendered (the size of rate rebates under this approach would be a matter of "judgement" and again not tied to earnings) and then rescind the rate rebates once service quality returns to acceptable levels.

PLAN STRUCTURE AND PROPOSED MODIFICATIONS

Q. What is the purpose of this section of your testimony?

A. In this section I describe the various components of the alternative regulation plan, including modifications that should be made on a going-forward basis.

Q. What are the components of the Ameritech Illinois alternative regulation plan?

A. AI's prices (PCI) are set by a formula which includes a measure of inflation (I), a productivity offset (X), an exogenous change factor (Z) and a service quality index (SQ) as follows.

Current year $PCI_t = PCI_{t-1}(1+I_t-X+Z_t-SQ_t)$

PCI_t is the price cap index for year t

PCI_{t-1} is the price cap index for year t-1

I_t is the inflation factor for year t

X is the productivity offset

Z_t is the impact of exogenous changes for year t

SQ_t is the service quality component for year t

where X = 4.3% currently

Q. Are you proposing any change to the inflation measure?

A. Yes. I recommend that the “chain weighted” GDPPI be used instead of the fixed weight GDPPI for two reasons. First, the “chain weighted” GDPPI has replaced the fixed weight GDPPI as the most commonly used inflation measure in the economy. Second the methodology used to compute the “chain weighted” GDPPI is closer to the methodology used to compute Ameritech’s input prices than the methodology used to compute the fixed weight GDPPI. In particular, the methodologies used to compute “chain weighted” GDPPI and Ameritech’s input prices allow for changes in the composition of output or input whereas the methodology used to compute fixed weight GDPPI does not.

Q. Please provide a description of the “X” factor.

A. The X factor in the price cap formula determines the extent to which Ameritech can raise or lower prices in a particular year. An X factor of 4.3% for example, means that

Ameritech could, at most, raise its overall prices by inflation minus 4.3%. In its Order in Docket 92-0448/93-0239 (consol.), the Commission included three components in its calculation of the X factor: a total factor productivity (TFP) differential of 1.3% per year; an input price differential of 2.0% per year; and a consumer dividend of 1% per year[1]. Added together these account for the 4.3% annual X factor the Commission adopted.

Q. Please explain what the terms "productivity differential", "input price differential" and "consumer dividend" mean.

A. The productivity differential measures the difference between telecommunications productivity gains and overall economy productivity gains. Productivity in this context refers to total factor productivity, which is defined as the ratio of total output to total input. Productivity gains are computed as the percentage change in output minus the percentage change in input. Output refers to the quantity of services or products produced by a firm, industry or economy. In telecommunications, output consists of access lines, local and long distance messages, installation etc. Input refers to the resources used to produce output and is usually classified as either labor, capital or materials. Other things being equal, if productivity grows faster in a particular industry than it does for the economy as a whole, then output prices in that industry will rise at a slower rate than output prices in the economy as a whole.

[1] Docket 92-0448/93-0239 (Consol.) Order at 40 (October 11, 1994)

Input price differential measures the difference between telecommunications input price growth and overall economy input price growth. Input prices consist of the prices of labor, materials and capital. Capital prices depend upon depreciation costs, equity costs, debt costs as well as corporate income and related taxes. Other things being equal, if input prices for a particular industry rise at a slower rate than input prices for the economy as a whole, then output prices for that industry will rise at a slower rate than output prices for the economy as a whole.

Finally, the consumer dividend is a factor imposed by the Commission based upon its judgement and expectations. The consumer dividend reflects any increase in productivity gains arising from technological and/or regulatory change that the Commission anticipates.

Q. Would do you propose for the 'X' factor going forward?

A. I propose a forward-looking X factor of 4.3%.

Q. Is this figure derived from Ameritech's historical performance or is it based on industry wide data?

A. I propose that the X factor be based on industry data rather than Ameritech Illinois data because industry-wide data yields the economically appropriate productivity differential and input price differential to use. In competitive markets, firms that surpass industry productivity performance are rewarded with higher earnings while those that lag industry performance suffer from poorer earnings. Firms with average productivity growth will earn just enough to keep them in business. Since the price cap formula is supposed to emulate the workings of a competitive market, the parameters should therefore be based on industry rather than company specific data. In addition, industry data is less subject to manipulation than company data.

Q. Please describe your proposed productivity differential.

A. I recommend a productivity (TFP) differential of 2.3%. This figure was obtained from the United States Telecom Association (USTA) productivity study results filed by Mr. Meitzen (Ameritech Exhibit 2.1 Attachment 2). Staff, however, has not had sufficient time to properly assess the methodology used by Mr. Meitzen in the USTA study and consequently reserves the right to revise its proposed productivity differential in the future as a result. In particular, Staff has reservations about the way in which Mr. Meitzen estimates the cost of capital for telecommunications carriers. In the Ameritech productivity study, Mr. Meitzen used separate debt and equity components, and a specific debt to equity ratio. Moreover he employed debt and equity costs unique to Ameritech to estimate the cost of capital for Ameritech. In the industry study, Mr. Meitzen does not use separate debt and equity costs for the industry nor does he use a separate debt/equity ratio. Moreover, his proxy for capital costs is not unique to the industry but in fact is a measure that pertains to the economy as a whole. At this point it is unclear what kind of biases, if any, such a methodology introduces into his estimate of industry productivity gains.

Q. Please explain your proposal for the input price differential.

A. Again, I propose that the input price differential be based on industry data. According to the USTA input price results filed by Mr. Meitzen, the historical input price differential between the industry and the economy is 1%. Again, Staff reserves the right to revise its proposed input price differential once it has more time to properly assess the methodology used to produce the USTA results but has the same kind of concerns I identified previously.

Q. What is your proposal for a consumer dividend?

A. I propose the consumer dividend remain at 1%. Ameritech Illinois has demonstrated that it can perform well financially under an X factor that includes a 1% consumer dividend. Moreover, it is unlikely that a company would opt for price cap regulation based on industry benchmarks if it did not believe that it could beat those benchmarks. It is also important that consumers see some tangible benefit from alternative regulation as well. At this point in time many subscribers may feel that the benefits from alternative regulation are tilted towards the company and all they are getting from alternative regulation is questionable service. Moreover, Section 13-506.1 (b)(5) of the Public Utilities Act requires that any alternative regulation plan or modified plan "…specifically identifies how ratepayers will benefit from any efficiency gains, cost savings arising out of the regulatory change and improvements in productivity due to technological change".

In its Final Order for Docket 92-0448/93-0239(Consol.), the Commission concluded that inclusion of a consumer productivity dividend was the most direct and appropriate way to ensure achievement of these goals. In Staff's opinion this continues to be the case, and as a result there is no reason to change this component of the "X" factor. Consequently, I am proposing an "X" factor of 4.3%, 2.3% for the productivity differential, 1% for the input price differential and 1% for the consumer dividend.

Q. Are you proposing any change to the exogenous change factor?

A. Yes. The Company should be allowed to implement exogenous changes in a timely manner under externally imposed circumstances such as Commission orders resulting in significant revenue decreases. It is desirable from a public policy standpoint to institute a systematic and predictable mechanism for revenue recovery under these circumstances. Consequently, I propose that the Commission allow the Company to file for an exogenous change within 30 days of such a revenue reduction with the specific rates it wishes to change. The proposed rate changes would then be reviewed by Staff. Final rate changes necessary for revenue recovery would then be implemented no later than 60 days after the initial Company filing. Under extraordinary circumstances the Commission could delay rate changes until the annual price cap filing, or deny revenue neutrality.

Q. Please describe the service quality component of the current plan.

A. Currently, Ameritech Illinois' performance is evaluated with respect to 8 benchmarks set out by the Commission. The Company is assessed a penalty of 0.25% for every missed benchmark for a total permissible adjustment of 2.0%. If the Company missed one benchmark for example, 0.25% would be subtracted from the PCI for that year.

Q. Does the service quality component need to be changed?

A. Yes. Currently, it does not matter whether the company misses the established benchmark by an inch or a mile since only 0.25% is deducted from the PCI in either case. Consequently, if the Company feels that it is going to miss a particular benchmark for the year, it has no incentive to do the best job it can under the circumstances. The solution is to structure the penalties in such a way that it is in Ameritech Illinois' interest to meet the quality target or get as close to it as it possibly can. One way to do this is through a graduated series of penalties. The more the Company misses the target for any particular indicator the more the penalty is. In addition, the penalties should take effect as soon as the problem develops. At the present time penalties are only assessed once a year at the time the price index for

Ameritech Illinois' services is changed. Another potential solution is to implement different penalties for different benchmarks, i.e., give Ameritech stronger incentives to meet certain benchmarks than others. Finally, those impacted by poor service should, to the extent possible, be compensated for the poor service through credits or their equivalent. Currently, penalties are implemented through general rate cuts which are spread over the entire subscriber base. As a result, most subscribers receive a very small and perhaps unnoticed rate cut from service penalties imposed on the Company.

For all these reasons Staff believes that service quality issues are best addressed outside of the price cap formula. The price cap formula is simply too crude an instrument to handle the complexities of service quality. Consequently, Staff recommends that the service quality component should be eliminated from the price cap formula. More appropriate solutions for current service quality problems will be addressed by Staff witnesses Ms. Jackson (Staff Exhibit 9.0) and Mr. McClerren (Staff Exhibit 8.0). However, these witnesses have also prepared an alternative based on keeping service quality in the price cap formula if the Commission determines that such an outcome is warranted.

MORE MODERATE GROWTH IN THE ECONOMY WILL NOT NEGATIVELY IMPACT AMERITECH'S ABILITY TO EARN

Q. The economy has been very strong the last few years. Would more moderate growth in the economy negatively impact Ameritech Illinois' ability to achieve

satisfactory earnings under alternative regulation by lowering its productivity growth and should we adjust the X factor downward to take this into account?

A. No. Contrary to what some of Ameritech Illinois' witnesses may have implied, more moderate growth in the economy will not likely compromise AI's ability to earn adequate returns under alternative regulation. More moderate growth in the economy may reduce the economy's and AI's productivity gains but Ameritech Illinois will be compensated by a higher inflation factor which will counterbalance the reduction in productivity growth.

This concept can be best illustrated by the following example. Suppose growth in the economy slows and as a result economy-wide productivity gains are reduced by 1% from what they were. Also suppose that AI's productivity gains are reduced by 1% from what they were as well because of weaker demand for its services. The 1% reduction in economy-wide productivity growth will other things being equal, raise economy-wide inflation by 1%. Consequently, although AI's productivity gains are 1% lower, the prices it can charge consumers are 1% higher (because of the rise in the inflation factor in the price cap formula). AI is therefore insulated from changes in economy-wide growth by the present price cap formula. A slower economy will adversely affect AI's ability to earn if it impacts Ameritech Illinois' productivity growth more than it impacts economy-wide productivity growth. But there is no reason to believe that this will be the case.

In fact demand for AI's services tends to be less sensitive to overall economic conditions than demand for other goods and services in the economy. Households do not typically disconnect their phone or drop voice mail or use the internet less when one or even two members of a household lose their job. Households will, however, postpone purchase of a new car, a new house, new furniture or delay a vacation when this occurs. Consequently Ameritech Illinois' productivity growth is less sensitive to changes in general economic conditions than productivity growth in most other sectors of the economy. This is borne out by USTA productivity data supplied by Mr. Meitzen. According to his figures, productivity for local exchange carriers (LECs) rose each and every year from 1989 to 1998 whereas economy wide productivity declined in the years 1989, 1990 and 1991 - a period of recession/slow economic growth. The average annual productivity differential between the LECs and the economy during these three years was approximately 3%, versus 2.3% during the recession free 1992-1998 period[2].

AMERITECH ILLINOIS HAS NOT BEEN FORCED TO PASS THROUGH MORE PRODUCTIVITY GAINS THAN IT ACTUALLY ACHIEVED HISTORICALLY

Q. Mr. Gebhardt claims that the 1% consumer dividend has had the effect of forcing Ameritech Illinois to pass through more 'productivity gains' than it actually achieved historically[3]. Please comment.

[2] Ameritech Illinois Ex. 2.1, Attachment 2, page 1.
[3] See Ameritech Illinois Ex. 1.1 p. 30

The issue of whether ‘productivity gains’ (in this context productivity gains refer to the combined historical productivity differential and input price differential between Ameritech and the economy which Mr. Meitzen estimates averages 3.5% per year) were passed along or not is best examined on a company wide basis. Between 1994 and 1999 (the period during which alternative regulation was in effect) Ameritech raised overall prices on average by about 0.5% per year. During the same period overall inflation in the economy (as measured by the chain weighted GDPPI) averaged approximately 1.8% per year. Consequently, Ameritech Illinois passed along only 1.3% of the 3.5% annual average productivity gains it achieved during this period. To summarize, AI has passed on fewer productivity gains than it actually attained on a company-wide basis rather than more as Mr. Gebhardt asserts.

There is a more fundamental way to examine this question. If Ameritech Illinois was forced to pass on more productivity gains than it achieved during the price cap period then its financial performance would have deteriorated. This does not appear to have been the case.

Staff notes that it has not had sufficient time to properly assess the methodology and assumptions used to compute AI’s reported productivity and input price performance and is awaiting responses to its data requests in this regard. More specifically, Staff has questions about the equity and debt costs along with the debt/equity ratio used by Ameritech in its productivity study. Consequently, Staff’s use of Ameritech Illinois’ productivity results as filed should not be construed as acceptance or endorsement of these results. Staff used Ameritech's own results only to demonstrate the lack of merit in Mr. Gebhardt's assertions. Staff reserves the right to update the figures used in the preceding analysis once it has established what AI's historical productivity and input price performance actually were.

Q. Does this conclude your testimony?

A. Yes it does.